U.S. Senate Republican Policy Committee
Established 1947

May 6, 2003

A Look at the States' Fiscal Crisis

Introduction

The states, collectively, are facing their worst budget deficit since World War II. The latest report by the National Conference of State Legislatures (NCSL) says the states face a $21.5 billion deficit for the budget year (which ends June 30th in most states).[1] The report projects an additional $53.5 billion of deficit spending next year. Of the 49 states with balanced budget provisions, 36 of them are dealing with deficit spending. Next year, 45 are expected to see deficit spending. Since the last quarter of FY 2000, aggregate state budget deficits have grown from $0.00 to more than $61 billion. This paper will address factors contributing to the current fiscal crisis within the states, outline what the states are seeking from the federal government, and examine what Congress is considering giving them.

Factors Contributing to the States' Fiscal Crisis

Revenues

Kentucky Governor and National Governors' Association (NGA) Chairman Paul E. Patton recently noted in a press statement, "We are entering the third year of state revenues inadequate to meet existing commitments. States have spent down their reserves."[2] Those reserves, known as "rainy day funds," had been built up to nearly $49 billion in the late 1990s. Most states have some sort of balanced budget requirement, but in the absence of reserves, and because of falling revenues, roughly 75 percent of those states have resorted to deficit spending.

This dramatic reversal of fortunes came as a result of a decade-long upward trend in tax revenues that suddenly failed to materialize at decade's end. Overall, from 1991 to 2000, state tax revenue grew 74 percent, or at an average of 7.4 percent per year, and federal grants-in-aid to states increased 88 percent during the same time, or at an average of 8.8 percent per year.[3] Data from the U.S. Census Bureau, National Association of State Budget Officers (NASBO), and National Income and Product Accounts (NIPA) show total state tax revenues rose above the previous year's level for the last time in FY 2001.

But the average annual percent increase in total state tax collections for FY's 1998, 1999, and 2000, was even higher (8.5 percent) than the average annual increase of 7 percent that carried for much of the previous decade. This no doubt gave governors reason to be optimistic that the trend would continue. Instead, in 2001, the total state tax revenue growth rate fell dramatically (sources vary by how much)[4] – and revenues since have continued to decline. In FY 2002, there was no growth in state tax revenue – rather, it declined by 4.6 percent from the previous year. Data for the first three months of FY 2003 indicate further declines.

Spending

From 1991 to 2000, state and local government spending (that is, total state expenditures less federal grants in aid) increased by 56.21 percent, or at an average of 5.6 percent per year.[5] During that same period, Gross Domestic Product (GDP) increased by 64 percent, or at an average of 6.4 percent per year. By comparison, total federal government spending during that same period increased by a more modest 41.8 percent, or at an average of 4.2 percent per year. State and local government spending surpassed GDP growth in 1999 and remained above the GDP growth rate until 2002, when the rate was slightly lower than GDP growth, but only by less than one-tenth of a percent. Federal spending, in comparison, did not outpace GDP growth until after September 11th as a direct result of a recession, the costs associated with the terrorist attacks, and having to finance a global war on terrorism.

By about 1998, continued state and local government spending increases began to erode away the surplus of revenues that had been growing in state rainy day funds since 1992. Between 1998 and the end of FY 2000, the states' collective surplus shrank from an all-time high of nearly $49 billion to a deficit of $200 million.[6] Spending growth during that period increased from 5.1 percent to 8.4 percent while revenue growth remained steady around 8.5 percent.[7]

Another comparison some economic analysts use to put spending into perspective is how much spending is growing relative to personal income. A study published by the American Legislative Exchange Council (ALEC), a bi-partisan state policy group, finds that in 1990, for instance, state and local spending consumed about $116 of each $1000 in personal income; by 2002, that figure had risen to roughly $123.[8] In 2002, that translated to state and local spending consuming 15.2 percent of U.S. personal income, the highest level since record-keeping began in 1929.[9] Bureau of Economic Analysis (BEA) data shows that in 2002, spending rose 4.9 percent to a record $1.36 trillion, while personal income grew 2.8 percent.

Yet another way some economists measure state spending levels is by comparing them to inflation rates. From 1992 to 2002, state and local government spending grew faster than the average rate of inflation (combined with population growth).[10] A comparison of data collected by the U.S. Census Bureau shows that during this period state spending grew 24 percent faster than that benchmark.

A study by the CATO Institute shows the positive effect limiting expenditures during the 1990s to that benchmark could have had on state budgets. The states could now have reserves of up to $93 billion. (In fact, several states did limit spending to the benchmark growth rate, and they saved significantly more on average than the states that did not.)[11]

Rising Costs in Special Education, Healthcare, and Homeland Security Programs

Medicaid

Total spending on Medicaid this year, including all federal and state expenditures, is slated to amount to nearly $280 billion.[12] That is a $37-billion increase (15 percent) over last year's total. Total Medicaid expenditures have been rising dramatically since 1995, and they are expected to continue to grow.

Of the above total, the federal portion is expected to reach $162.3 billion, an increase of 10 percent from last year.[13] The Office of Management and Budget (OMB) anticipates federal funding for the program to again grow by more than 12 percent in FY 2004.[14] Meanwhile, state and local government spending on Medicaid in FY 2003 is estimated to be about $117.7 billion, an increase of 6.4 percent from the previous year.[15] According to a study by NASBO, in 1992, Medicaid spending represented 17.8 percent of total state spending, but in 2002, it surpassed 20 percent. Some of the fastest growing costs to the states involve nursing home and institutional care, which together account for 50 percent of the Medicaid budget in some states.[16] Prescription drug costs are also notable cost drivers.

To minimize the strain that rising Medicaid costs are having on state budgets, the NGA and the NCSL propose a temporary increase of approximately 10 percent (which would translate to roughly $15 billion) in the Federal Medical Assistance Percentage (FMAP), the formula used to calculate how much federal money each state gets for Medicaid.

Special Education

The Individuals with Disabilities Education Act (IDEA) is the primary federal statute that provides funding to the states for special education and related services for children with disabilities. In order to receive federal funds under IDEA, the Act requires states and local educational agencies to provide a free public education to each eligible child with a disability. In 1981, Congress authorized the federal government to pay up to 40 percent of each state's "excess cost" of educating children with disabilities – sometimes called the IDEA "full-funding" amount. Just five years earlier the authorized federal funding amount was at 5 percent. The dramatic increase in the authorized federal share of these costs from five percent to 40 percent in just 5 years was based on the assumption that educating children with disabilities is on average about twice as expensive as educating other children.[17]

Although Congress has substantially increased IDEA funding since 1981 to about 20 percent of the authorized 40 percent funding level, or nearly $10 billion, the current full-funding amount has never been attained. As a result, NCSL and state educators are urging the federal government to appropriate "full funding" for the costs of educating children with disabilities under IDEA. Resolutions to this effect have been passed in Congress, and legislation has been proposed, that would set specific authorization targets for achieving full funding in future years. Legislation has also been proposed that would make full funding mandatory. The debate has recently been elevated as a result of the states' fiscal crisis.

No Child Left Behind Act

The National Conference of State Legislatures and state educators also are seeking additional federal aid to help the states pay for provisions under the No Child Left Behind Act, which states and local school districts use to turn around low-performing schools, improve teacher quality, and ensure that all children have a chance to succeed in their educations. NCSL argues that the states will not be able to afford the costs for new achievement assessments and performance evaluations required under the program for this year and next year. The deadline for submitting state plans to implement the requirements under this Act was the beginning of this year. To date sixteen states have gained Department of Education approval for their plans.

Homeland Security Costs

NCSL further seeks more federal assistance for Homeland Security costs, including funds to prepare "first responders" for terrorist acts occurring within their states. They note that while the FY 2003 budget appropriated $3.5 billion for first responders, only $1.3 billion of that is actually dedicated to anti-terrorism, as opposed to non-terrorism-related emergencies like natural disasters.[18] NCSL advocates additional funding for expenses such as paying state law enforcement officials overtime wages to protect areas within their states from terrorist attacks and for various costs associated with preparing their states for a bio-terrorism attack.

A Look at the States' Requests to Congress

Speaking on behalf of the states, the NCSL and NGA have urged Congress to endorse legislation that would increase federal funding to help pay for "unfunded mandates" under the above-mentioned programs for which they say the federal government should bear more of a responsibility. Specifically, NCSL and NGA officials say that rising costs associated with federal health care programs, such as prescription drug costs, justify a system of 'dual eligibles' where the federal government pays for the entire cost of prescription drugs under Medicaid, or at least provides a temporary additional increase in federal assistance to the states. Both organizations also say that special education funding authorized under the Individuals with Disabilities Education Act (IDEA) has not been adequate, nor has federal funding for requirements under the No Child Left Behind (NCLB) Act. Furthermore, the NGA and NCSL say that new national expectations for Homeland Security are putting an additional strain on the states' budgets.

The Federal Government is Responding to the States' Fiscal Crisis

Three pieces of legislation (the FY 2003 Omnibus Appropriations bill, the FY 2003 Supplemental, and the final FY 2004 Budget Resolution conference report) provide a solid indicator that the federal government has not only taken serious notice of the states' fiscal predicament but is sympathetic to helping them. A look at how this Administration and federal lawmakers are responding to what the NGA and NCSL say the states need to get back on their feet provides a better understanding of how the federal government views its role of responsibility in helping the states. Most of the increased funding is specifically targeted to aid a particular program the states have expressed concern over, such as Homeland Security, special education, and state healthcare programs like Medicaid and SCHIP. However, there is also some language in the final Budget Resolution conference report (H.Con.Res. 95) that shows there are some in Congress who feel the states should also receive some immediate discretionary funds, or what NCSL and some federal lawmakers have termed "temporary emergency funding." Sense of the Senate language in two such cases could provide up to $40 billion and $30 billion respectively. (Senses of the Senate are not binding and are therefore budget neutral.)

What the National Governors Association (NGA) and National Conference of State Legislatures (NCSL) say the States Need.	**What Congress has Appropriated and is Considering Giving the States for FY 2003 and FY 2004.**
Prevent unspent funds for the State Children's Health Insurance Program (SCHIP) from reverting to the federal treasury.	In H.Con.Res. 95 (the final Budget Resolution conference report), current language extends to the states the availability of expired SCHIP funds for one year and creates a reserve fund of $1.825 billion to be reallocated to the states in $975 million in outlays over 10 years.
Provide first responder block grants at the president's recommended 'First Reponder Initiative' level of $3.5 billion for FY 2003.	The combined FY 2003 amount provided to the states for programs that correspond to the president's 'First Reponder Initiative' is roughly $4.33 billion, some $830 million more than what the states originally asked for: includes roughly $2.045 billion in in the Omnibus Appropriations bill (P.L. 108-7), and roughly $2.285 billion in the FY 2003 Supplemental (P.L. 108-11).
Provide a temporary, unconditional boost in the Federal Medicaid Assistance Program (FMAP) matching funds to the states for FY 2003 and FY 2004.	Language in H.Con.Res. 95 includes a Sense of the Senate provision that calls for roughly $15 billion to be directed toward Medicaid. Although it is unclear as to what the final assistance amount will be, it is clear that Congress is concerned with giving the states some assistance with Medicaid costs.

Provide an immediate increase of at least $11 billion for Special Education programs such as the Individuals with Disabilities Education Act (IDEA). (That number is based on the amount the federal government would have to send to the states this year on top of what they are already providing in order to fund IDEA at 40% of the costs of educating children with disabilities.)	H.Con.Res. 95 includes Sense of the Senate language that would provide the states with discretionary funding in the form of a block grant which could total between $30 billion to $40 billion – states could use some of this to assist with education programs. Additionally, H.Con.Res. 95 increases IDEA grants from $8.9 billion to $11.0 billion ($2.2 billion increase). Title I grants increase from $11.7 billion to $12.7 billion ($1 billion). An IDEA reform bill which would further increase authorization is pending.
Provide at least $5 billion more in funding for the No Child Left Behind Act (NCLB).	Funding for the NCLB is increased from $23.6 billion to $24.1 billion ($0.4 billion increase).
Provide $100 million for Phase II of the smallpox vaccination program for first responders. NCSL estimates the combined costs for implementing Phase I and II at $200 million.	The FY 2003 supplemental provides $100 million for smallpox vaccinations. Phase I is less than 50% complete and costs for Phase II have not yet been adequately determined.
Provide a compensation fund for individuals with injuries resulting from smallpox vaccinations.	The FY 2003 supplemental provides $42 million into a fund to compensate individuals with injuries resulting from the small pox vaccine and related countermeasures.
Increase state highway funding.	H.Con.Res. 95 increases funding for highways from $30.6 billion to $35.5 billion (an increase of $4.9 billion or nearly 14%). Furthermore, S. 201, a Sense of the Senate amendment added to H.Con.Res. 95, would provide $40 billion over one year in temporary assistance divided equally between state and local governments to be used for, among other things, highway construction.
Increase funding for child care.	H.Con.Res. 95 increases funding for child care from $4.8 billion to $5.2 billion (an increase of $0.4 billion or nearly 8%). Furthermore, S. 201, a Sense of the Senate amendment added to H.Con.Res. 95, would provide $40 billion in temporary assistance divided equally between state and local governments to be used for, among other things, child care.

Increase funding for Medicaid.	In addition to the Sense of the Senate amendments adopted which would provide for increased Medicaid funding, and in addition to the provision in H.Con.Res. 95 that would make available to states expired SCHIP funds, the Budget Resolution increases general grants for Medicaid to the states from $158 billion to $177 billion (an increase of $19 billion).
Provide funding for federally-mandated, but uncompensated, emergency health-care and incarceration costs for illegal immigrants.	If passed, Republican-led legislation in the Senate (S. 412) would provide $1.45 billion per year to reimburse states for costs under a federally mandated law that requires states to provide emergency medical treatment to illegal immigrants; other Republican-led Senate legislation seeks to reauthorize funding to states under the State Criminal Aliens Assistance Act (SCAAP).

Sources: H.Con.Res. 95 Conference Agreement; National Conference of State Legislatures (NCSL) (*See* http://www.ncsl.org/programs/press/2003/030424.htm); Ben Canada and Shawn Reese, "FY 2003 Appropriations for First Responder Preparedness: Fact Sheet," CRS Report for Congress, Congressional Research Service, April 17, 2003.

Conclusion

Before he became president, George W. Bush explained the various circumstances under which he could foresee running a federal budget deficit: in the event of a recession, a national emergency, or a war. Due to an unfortunate confluence of events, all three circumstances now face the nation.

Volumes can be written about how the federal government has failed to restrain spending, does not provide enough money for unfunded mandates, and fails to provide enough border security for certain states. But while the federal government faces deficit spending, most of the 36 states currently engaged in deficit spending took a different path to arrive at their deficits. The reality is that, while federal spending stayed below the economic growth rate, at least until 2001, and federal grants-in-aid were keeping up, state spending was outpacing it. Meanwhile, recent state revenue predictions were overly optimistic.

The states' fiscal crisis is likely due to a combination of several factors, including state spending rates that began to outpace GDP growth in 1999; further contributing were overly optimistic revenue projections over the past two years due to a softening economy. In contrast, total federal spending has kept up with the economic growth rate, and federal payments to the states in the form of grants-in-aid increased by nearly 90 percent during the 1990s.

But the federal government clearly recognizes that there are areas in which it can help the states with increased fiscal assistance and this administration and this Republican Congress are making that happen right now. The most important piece of pending legislation that will help the states, however, is the President's growth package, which stands to create more jobs, generate more taxpayers, and infuse state economies with increased revenue levels to close their budget gaps. With new jobs and significant tax relief for Americans along with improved education and healthcare delivery, the economy will recover and the states will surely benefit.

Written by Nathaniel Fogg, 224-2946

End notes:

1. “Three Years Later, State Budget Gaps Linger,” National Conference of State Legislatures (NCSL), press release (*See* http://www.ncsl.org/programs/press/2003/030424.htm), April 24, 2003.

2. National Governors Association (NGA), press release (*See* http://www.nga.org/nga/newsRoom/1,1169,C_PRESS_RELEASE^D_5079,00.html).

3. All tax revenue data is from the U.S. Census Bureau website; RPC calculation of increase in grants to state and local governments is from “Economic Report of the President: 2003,” (ERP’03) Council of Economic Advisors (CEA), February 2003, which is based on data from the National Income and Product Accounts (NIPA) tables found on the Department of Commerce, Bureau of Economic Affairs (BEA) website, last updated April 25, 2003.

4. Data from the U.S. Census Bureau show a decline in the annual fiscal year growth rate of total state tax revenues from 8.0 percent in FY 2000, to 2.1 percent in FY 2001; data from NIPA (used by the Office of Management and Budget (OMB) to create the federal budget) and National Association of State Budget Officers (NASBO) (used by the states to create their budgets) shows a sharper decline from 8.5 percent growth in FY 2000 to just 1.3 percent growth in FY 2001.

5. RPC calculations in this paragraph on state general fund spending and Gross Domestic Product (GDP) rates are based on data obtained from NIPA, tables 1.1 and 3.1; and, ERP’03.

6.ERP’03 (NIPA tables).

7. Ibid.

8. Richard Vedder, Ph.D, “Should the Feds Bail Out the States?”, ALEC, February 2003.

9. Dennis Cauchon, “States, localities spending hits high,” *USA Today*, April 24, 2003.

10. NIPA, tables 1.1 and 3.3; and Richard Vedder, Ph.D.

11. Chris Edwards, Stephen Moore, and Phil Kerpen, “ States Face Fiscal Crunch After 1990s Spending Surge,” CATO Institute, February 12, 2003.

12.“NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003, NASBO, March 15, 2002; “FY 2004 Budget in Brief,” U.S. Department of Health and Human Services (HHS), February 2003, p. 57.; “Budget of the U.S.: Historical Tables 2004,” February 2003.

13.“FY 2004 Budget in Brief,” HHS.

14.“NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003.”

15. Ibid.

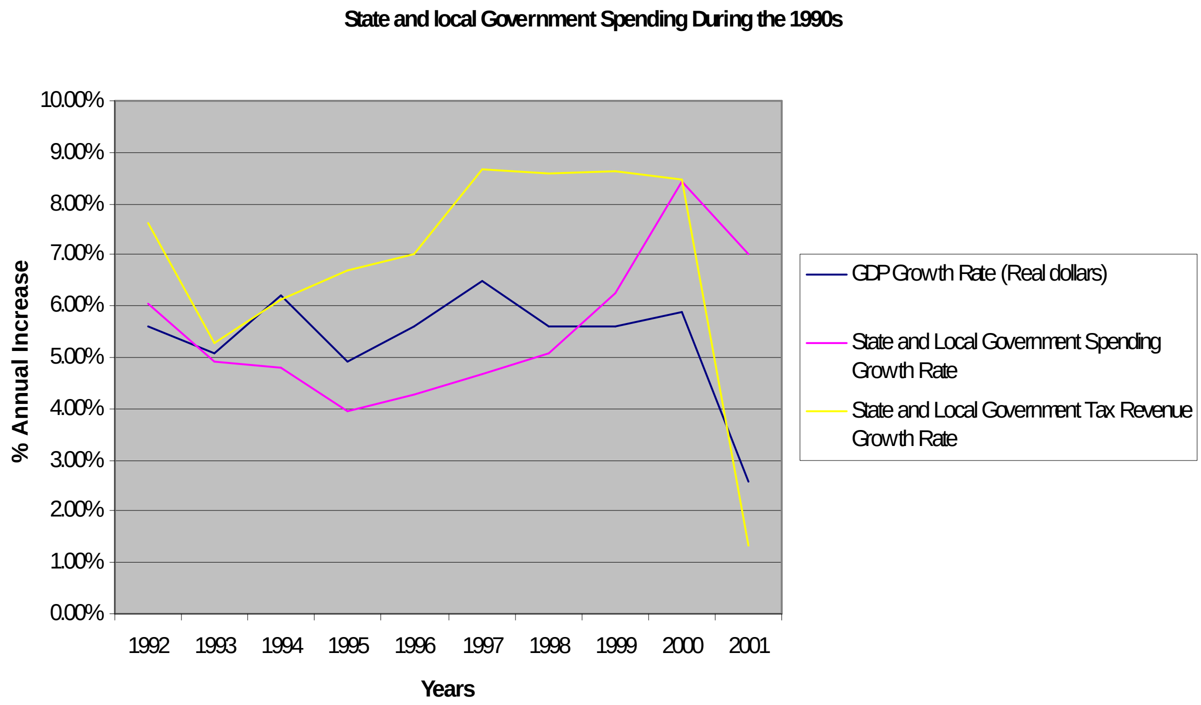
16. James Frogue, “The Future of Medicaid: Consumer-Directed Care,” The Heritage Foundation, January 15, 2003; “NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003.”

17. Richard N. Apling, “Individuals with Disabilities Education Act (IDEA): Issues Regarding ‘Full Funding’ of Part B Grants to States,” Congressional Research Service, February 15, 2001; According to this study the total cost

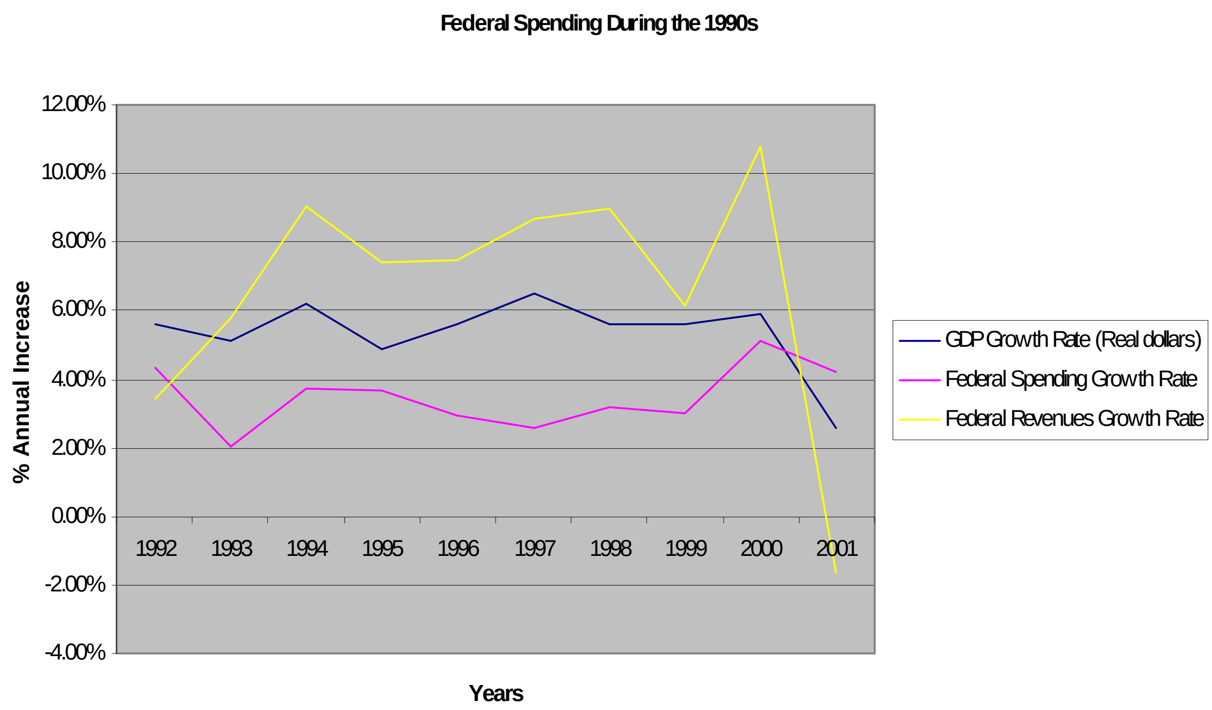
to the states of special education during the 1999-2000 school year was $50 billion, which amounted to $8,080 per special education student. Adjusting for inflation, the cost of special education services in today's dollars is probably now closer to about $58 billion or $59 billion. The additional expenditure to educate the average student with a disability was estimated in 1999-2000 to be $5,918 per student. This is the difference between the total expenditure per student eligible for special education services ($12,474) and the total expenditure per regular education student ($6,556). The total spending per pupil to educate the average student with disabilities was 1.9 times that expended to educate the typical regular education student with no special needs.

18. David Lightman,"Pressing Bush On Security Funds," The Hartford Courant, February 24, 2003.

Chart Appendix



Source: RPC calculations based on data from the U.S. Census Bureau and NIPA tables.



Source: RPC Calcultions based on data from U.S. Census Bureau and NIPA tables.